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AGC of America
THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA
Quality People. Quality Projects.

September 11, 2015

Internal Revenue Service
CC:PA:LPD:PR (Notice 2015-40)
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Notice 2015-40 – Request for Comments Regarding New Financial Accounting Standards Board and International Accounting Standards Board Revenue Recognition Standards

Dear Sir or Madam:

On behalf of the Associated of General Contractors of America (AGC), I respectfully submit the following comments in response to Notice 2015-40 to the Request for Comments Regarding New Financial Accounting Standards Board and International Accounting Standards Board Revenue Recognition Standards. We appreciate the efforts of the Internal Revenue Service in soliciting comments regarding these changes.

AGC is the leading and oldest national construction trade association in the United States. AGC AGC's nearly 30,000 member companies are engaged in all forms of non-residential construction – including the nation's commercial buildings and industrial facilities, highway and public transportation infrastructure, water and wastewater systems, flood control and navigation structures, utility infrastructure, defense installations, multi-family housing, and more.

The construction industry has played a powerful role in sustaining economic growth in the United States, in addition to producing structures that add to productivity and quality of life.

After significant input from our contractor and associate members, we have framed our comments corresponding to the specific questions asked in Notice 2015-40:

Question 1 - To what extent do the new standards deviate from the requirements of Section 451? How may they affect deferral of income?

Section 451 requires the amount of any item of income to be included in gross income for the taxable year received by the taxpayer, unless, such amount is to be properly accounted for as of a different period under the taxpayer's method of accounting used in computing taxable income. In the construction industry, advance payments pursuant to long-term contracts are generally included in income in the taxable year in which they are properly included in taxable income under the percentage of completion method under IRC Reg. 1.460-4.

Unlike the accounting standards for long-term contracts used today under SOP 81-1, the new standards eliminate industry specific revenue guidance. The new standards are principles-based and designed to be applied to all contracts with customers regardless of industry.

The percentage of completion method is effectively eliminated for financial reporting purposes. The core principal of revenue recognition under the new standards is that revenue is recognized as goods or services are transferred to

customers in an amount reflecting the consideration expected to be received. This concept is very similar to the percentage of completion accounting used today, thus income may be deferred on any advance payments until when (or as) the performance obligation identified in the contract is satisfied.

The new standards may create new differences between revenue recognized for financial reporting purposes and taxable income. For example, the new standards require the entity to identify any different performance obligations within the contract and then allocate the transaction price to these performance obligations. There will also be changes in the accounting for uninstalled materials, recognizing variable consideration in the contract in determining the transaction price, and the treatment of certain costs to obtain or fulfill a contract.

Question 2 – What industry and/or transaction-specific issues may arise as a result of the new standards that might be addressed in future guidance?

The construction industry will be affected by the new standards since currently revenue recognized under construction contracts is under the percentage of completion method of accounting on a cost-to-cost basis. The degree as to how much the new standards will affect contractors will depend on the complexity of the contract. The specific issues we feel may arise are as follows:

Uninstalled Materials

Based on the core principles of the new standards, if a customer obtains control of goods before they are installed, then the entity should recognize revenue for the transferred goods. However, if the entity applies the cost-to-cost method for measuring the progress, including the uninstalled materials in the cost-to-cost calculation could trigger a contract-wide profit margin before the goods are installed. In order to avoid this overstatement of revenue, the new standards allow entities to recognize revenue, but only equal to the cost of the uninstalled materials. In other words, when using an input method such as cost-to-cost to determine the amount of revenue recognized under a performance obligation, the standards recognize that the inclusion of uninstalled materials in the costs incurred may not result in a direct relationship between the contractor's inputs and the transfer of control of the project to the customer. The standards, therefore, require that the amount of uninstalled materials be excluded from the measure of costs incurred and from the transaction price. Therefore, revenue recognized for the transfer of the materials will always equal the costs of the materials, so no profit will result under the new standards until the materials are installed.

This would be a significant difference to most taxpayers required to use the percentage of completion method under IRC Section 460. The presumption for financial reporting purposes is that uninstalled materials is a zero-profit carve out of the contract, yet for tax purposes, the cost of materials are generally allocated to the contract when dedicated to the project and included in the total costs incurred in the cost-to-cost calculation and, thereby, accelerate the profit on the contract. Contractors may also avoid the calculation for the carve out for uninstalled materials for financial reporting purposes by selecting an output method in order to determine the percent complete, which could also be a significant difference between the profit recognized for financial reporting purposes and taxable income since only the cost-to-cost input method is allowed for contracts that are required to be accounted for under the percentage of completion calculation.

Multiple Distinct Performance Obligations within a Construction Contract: *If there are situations within a contract that distinct multiple performance obligations exist, it may be necessary to sever and account for the contract as two or more contracts for financial reporting purposes.*

Under IRC 460(f)(3), contracts can be severed if necessary to clearly reflect income. The purpose of severing a contract is to prevent the unreasonable deferral or acceleration of income. However, there is an exception under IRC Reg. 1.460-1(e)(3)(i) that prohibits a taxpayer from severing a long-term contract that would be accounted for using the percentage-of-completion method without obtaining the Commissioner's prior written consent.

Variable Considerations (for example Contract Claims, Unapproved Change Orders, Incentives)
Under current GAAP, claim revenue cannot be recognized until the revenue is fixed and determinable. The new guidance takes a more principle based methodology for constraining estimates of variable considerations and first requires an entity to estimate the consideration to which the entity will be entitled. The entity then assesses whether the objective of the guidance for constraining estimates of variable consideration can be met—that is, by determining whether it is probable that a significant revenue reversal will not occur when the uncertainty associated with the variable consideration is subsequently resolved. If the entity determines that it is probable that the inclusion of its estimate will not result in a significant revenue reversal, that amount is included in the transaction price.

In a 1996 Coordinated Issue Paper (CIP) titled "Claim Revenue Under A Long-Term Contract," the IRS concluded that the contractor must include the claim in the contract because the contractor could "reasonably estimate" that it would actually receive the additional compensation regardless of whether the all-events test has been satisfied. The CIP was subsequently revised in July 2006 and came to the same conclusion. In addition, under the 460 Regulations, the amount is included in the contract price no later than when the amount is included in income for financial reporting purposes under GAAP.

Variable consideration may not result in any transaction-specific issues. However, under the new standards, a change order could be accounted for as a separate contract for financial reporting purposes if both of the following are true:

a. *The scope of the contract has increased because of the additional promised goods or serviced that are distinct, and*
b. *The price of the contract increases by an amount of consideration that reflects the entity's standalone selling prices of the additional promised goods or services.*

As stated above under "Multiple Distinct Performance Obligations within a Construction Contract," a contract required to be accounted for under the percentage of completion method for tax purposes cannot be severed without written consent from the Commissioner.

Costs of Obtaining a Construction Contract
The new standards also call for certain costs to obtain or fulfill a contract with a customer that the entity expects to recover to be capitalized and amortized over the life of the contract, if they meet all of the following criteria:

- *Relate directly to the contract (or a specific anticipated contract)*
- *Generate or enhance resources of the entity that will be used in satisfying performance obligations in the future*
- *Are expected to be recovered*

However as a "Practical Expedient", an entity may expense these costs when incurred if the amortization period is less than one year.

Whether these costs are capitalized or expensed in the current year for financial statement purposes, the treatment of these costs is in stark contrast to the current treatment of costs allocation under IRC Section 460(c) for long-term contracts, which generally requires that all costs that directly benefit or are incurred by reason of long-term activities be allocated to the contract as incurred.

Question 3 – What type of changes in methods of accounting do taxpayers anticipate requesting?

Taxpayer's who have long-term contracts required to use the percentage of completion method may request permission to sever a contract in order to be consistent and conform to the accounting for the multiple performance obligations for financial reporting purposes.

Likewise, in situations where the customer obtains control of materials to be installed in a subsequent year, taxpayers may also make a request to sever a contract in order to account for the transfer of the uninstalled materials to the customer in an amount equal to the cost of the materials to be consistent and conform to the accounting of the contract for financial reporting purposes. This would only be the case if the taxpayer is not involved in designing or manufacturing the materials.

Question 4 – Do taxpayers anticipate requesting changes in methods of accounting prior to the effective dates of the new standards?

Nonpublic entities are required to adopt the new standards for annual reporting periods beginning after December 15, 2018. However, a nonpublic entity may elect to apply the new standards for annual reporting beginning after December 15, 2017. Those entities that adopt the new standards one year earlier may also want to change their accounting method for tax purposes to be consistent with their reporting for financial statement purposes. The transition process for the new standard includes mid-contract changes in the manner in which revenue is recognized for uncompleted performance obligations for the transition year. For taxpayers that desire to minimize timing differences, entities may be requesting permission to change the measurement of the contract price and percent complete computation based on applying the new standard to existing, partially performed contracts.

Question 5 – Should taxpayers be required to use the automatic consent accounting method change procedures or the advance consent procedures to request permission to change a method of accounting under the new standards, and why?

Taxpayers should be able to use the automatic consent procedures for a change in accounting method under the new standards. Since so many taxpayers in the industry will likely be affected by the new standards, the automatic change procedures would be less of a burden on taxpayers to request a change.

Question 6 – Which accounting method changes under the new standards, if any, should be allowed using a cut-off method instead of a section 481(a) adjustment, and why?

Taxpayers should be afforded a §481(a) adjustment when allowed under the current rules. The regulatory requirement for the cut-off method for changes in accounting for long-term contracts should be eliminated. From a tax policy standpoint, the objective should be to encourage taxpayers to comply with tax methods and procedures. Due to the size of transactions in the construction industry, relatively small entities can create significant timing differences between revenue recognition using cash, accrual excluding retention, or the completed contract method. The cut-off method is punitive to these companies whether it is applied due to the growth of average annual gross receipts above the $10 million IRC 460 threshold or if it is due to a change in method request. The sheer tax dollar cost of this transition often is an incentive for taxpayers to either not make a change in accounting method change or, unfortunately, ignore the requirement to change to the percentage of completion. The Treasury, as well as applicable construction companies, would be better served with eliminating the cut-off method entirely for transitions among long-term contract accounting methods.

Question 7 - Will advance or automatic consent procedures or other procedural guidance (such as Rev. Proc. 2004-34, 2004-22 I.R.B. 991) need to be modified and if so, how?

We do not foresee that advance or automatic consent procedures or other procedural guidance (such as Rev. Proc. 2004-34, 2004-22 I.R.B. 991) will need to be modified other than adding additional codes for changes required under the new standard to comply with GAAP.

Question 8 – What transition procedures may be helpful?

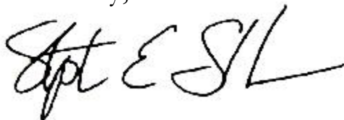
As we stated in Question 5 above, making the accounting method changes automatic would be helpful to taxpayers. We highly recommend that advance work be done in evaluating the adequacy of M-3 schedules prior to the effective date of the new standard. Since this form begins with book or audited financial statements, the transition year will be problematic to enter meaningful data by taxpayers or for IRS auditors to follow. This is because the prior year book retained earnings will be restated by almost all entities and there may be a number of individual transactions that make up the change.

Question 9 – What related accounting method changes do taxpayers anticipate requesting that may appropriately be made on a single 3115, *Application for Change in Accounting method*?

Taxpayers who otherwise are not required to use the percentage of completion method under section 460 may also want to elect the percentage of completion method along with changes related to the new standards.

Thank you for your request and consideration of our comments. Please let us know if you need further clarification or have any questions.

Sincerely,



Stephen E. Sandherr
Chief Executive Officer